NCM Client Notification

A publication of Northern Capital Management, Inc.

OCTOBER 8, 2008

Title: The Fed that learned its lessons well.....

To Our Clients:

As most of you are aware, today the Federal Reserve, in a concerted move with other central banks, cut interest rates by .5%.

While this does little to fix the issues at the crux of the problem, it is historically unprecedented and illustrates a global willingness to get ahead of this problem.

We have begun to hear comparisons being made to the Great Depression, which is nothing short of ridiculous.

In our Client Notification on October 6, 2008 we stated "Remember our role as your advisor is to dispel emotions, including optimism, from our thought process." Together let's evaluate why comparison of this crisis and the Great Depression is the chatter of fools.

The Federal Reserved caused the depression. This seems like a wild assertion, given the Federal Reserve was created through the Federal Reserve Act of 1913 to stabilize the banking system and economy. Unfortunately, there was a lack of understanding at the time of how to cope with crisis, such as the 1929 stock market crash or more accurately the years after the 1929 crash.

In the 12 months following the crash the Federal Reserve responded by allowing the money supply to contract by 2.9 percent - which seems small, but is significant.

The second mistake related to its role as lender of last resort. In other words, if banks experience a run, they need to be able to borrow money from the Fed at favorable rates to stave off collapse.

The mechanism used to back banks is referred to as the Discount Window. This is the lending facility through which banks borrow from the Fed. When they borrow, they pay an interest rate. In the Depression instead of lowering this key interest rate, more times than not they raised it thereby placing more stress on bank finances.

In 1931 the Fed engineered a huge increase in the discount rate, causing commercial banks to stop borrowing from the Discount Window and hoard cash to pay off depositors. This meant further reductions in lending activity. By August of that year commercial deposits had dropped 7% resulting in an additional contraction of the money supply.

Instead of flooding the system with liquidity (as they did in the very immediate aftermath of the 1929 crash) and supporting banks, the Fed sat back and allowed banks to fail in the South and Midwest. This in turn led to collapses of high profile institutions such as the Bank of the United States in New York. By the time the carnage was over only 15,000 out of 25,000 commercial banks remained.

A third misstep related to getting currency into banks to lend. The Fed through open market operations can inject capital into the market or into banks. Instead of using these mechanisms to inject, they did the reverse and used the mechanisms to draw capital out of the system. This in turn led banks to further hoard cash and not lend. By August 1932 deposits had contracted another 15%.

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By 1933 banks were reeling. In half the states, bank holidays were declared during which banks were not obligated to pay off their depositors. Instead of taking steps to discontinue the cycle, the Fed again raised the discount rate...causing more banks to collapse. In the end, the crisis peaked when the Fed itself closed on March 4th, 1933.

Do these missteps remotely resemble circumstances of today? I would suggest to you, the Fed learned its lessons from the Great Depression quite well.

In contrast to the response to the 1929 crash, the Fed has stepped in and injected billions into the money supply and continues to do so.

They have actively backed commercial banks protecting them from failure either through negotiated sales or transitions into the FDIC net. They have further boosted confidence in banks by raising FDIC insurance limits.

The Depression witnessed the failure of 10,000 banks. Year-to-date we have had 13 bank failures, 3 last year....and none in 2005 and 2006.

The Fed has lowered the discount rate from 6.25% in August of 2007 to 2.25% today and we expect this to come down further.

The Fed has taken a variety of other strong measures not even conceptualized in 1929.

Most importantly, the Fed in conjunction with the central government, has put into place a plan which will resolve the biggest outstanding issue, illiquid assets on the balance sheets of banks and financial institutions.

As you are aware from prior correspondence, we anticipate a government package aimed directly at mortgage foreclosures as well as an economic stimulus package.

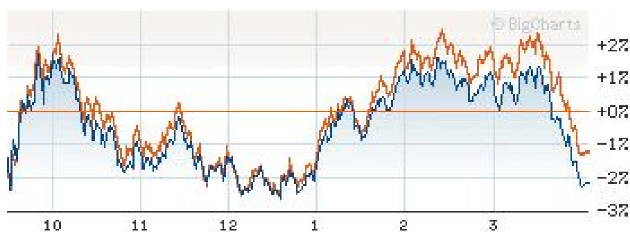
It seems reasonable the Fed consider insuring overnight loans banks make to each other. This would have the effect of immediately restoring confidence.

Finally, unemployment during the depression was 25%. Today it is 6.1%.

So now we turn our attention to the market. Another down day. Six in all!

Let us remind our investors what a market bottom looks like.

- High volume;
- Capitulation at all costs;
- The sky is falling;
- This time it is different;
- Fear;
- Pervasive bearishness.



The fact the market vacillated between triple digit gains and losses today tells you a tug of war is now occurring.

We are about to enter the third quarter earnings release season. In this environment it is hard to know if anybody will even be listening. Fear is not logical.

Current estimates show median earnings growth 9.76% in the third quarter, but this will provide little comfort to those staring into the abyss ahead. Even though fourth quarter earnings are projected to grow 11.28% it is very hard to predict.

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What we can predict is recovery. We cannot tell you the day or hour. But the downside of a slide looks like one side of a V and the path back up the other.

We received this e-mail today from a client….”Today's client notification mentioned that clients who would like to increase their risk should notify the firm. Well I would like to do that. I fundamentally believe that eventually this situation will stabilize and that time will present a market low and a great buying opportunity. Approximately 1-2 years ago, the firm reduced my stock exposure because of the proximity of my age, now 59. I have been hoping to retire before 65 -- which looks a bit questionable at the moment. To that end I would like to take advantage of this situation. Please pass this on to Jim Wilson. I trust that Jim and the other investors' judgment to determine a reasonable risk increase for me and my personal situation - as well as the duration of this increased risk.”

We think this type of rational thinking will prove to be wise…knee jerk reactions are not. In the end we do not want to try and out-think a panic. It cannot be done.

We will keep you posted.

Investment Committee
Northern Capital Management, Inc.

PS—A client today alerted us to the fact the US Treasury has come out with a new one dollar bill. You should be able to get these at your local bank very soon! Thanks Bill D!

Treasury Department has issued a new one dollar bill.........